

## Internal Revenue Service

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Department of the Treasury

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Refer Reply To:

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### Legend

Grantor                =  
Trust                 =

Husband             =  
Date 1                =  
Company 1            =  
Company 2            =  
Exchange            =

a                        =  
b                        =  
c                        =  
d                        =

Dear                 :

This is in response to your December 27, 2007 letter and other correspondence requesting income, gift, and estate tax rulings concerning the proposed exercise of a power of substitution.

The facts submitted are as follows:

On Date 1, Grantor executed Trust. Grantor's husband, Husband, serves as the initial trustee of Trust and will also serve as the initial trustee of Family Trust (discussed later).

Section 1.1A of Trust provides that the trustee is to hold, administer, and dispose of Trust as provided in Article I. It is intended that Grantor's retained annuity interest qualify as a qualified interest as defined in § 2702(b)(1) of the Internal Revenue Code.

Section 1.1B defines “annuity” as an amount equal to a% (less than 50%) of the initial net fair market value of the principal of Trust as finally determined for federal gift tax purposes.

Section 1.1C provides that the “GRAT term” begins on the day property is contributed to Trust and expires on the second anniversary of that date.

Section 1.1D provides, in relevant part, that no additional contributions are to be made to Trust under this Agreement after the initial contribution and prior to the expiration of the GRAT term. Although no additional contributions may be made to Trust, if any transfer is deemed made to the trustee, such deemed additional transfer is to be held by the trustee in a separate trust upon the same terms and conditions as the original contribution to Trust and such transfer shall not form a part of Trust.

Section 1.2A provides that the trustee is to pay on the day before each anniversary of the initial funding, or within b days thereafter, (i) the annuity to Grantor if Grantor is then living, or (ii) the greater of the income of the Trust and the annuity to Grantor’s estate if Grantor is deceased. The trustee is prohibited from issuing a note, other debt instrument, option, or similar financial arrangement in satisfaction of the obligation to pay the annuity. The instrument provides for a daily proration of the annuity between Grantor and Grantor’s estate for the period in which Grantor’s death occurs.

Section 1.2B provides that the payments to be made under the provisions of subsection A are to be paid from the income of Trust and, to the extent that such income is not sufficient, from the principal of Trust. If income for any year is in excess of the aggregate payments for such year, such excess income is to be added to principal.

Section 1.3 provides, in relevant part, that Trust terminates upon the expiration of the GRAT term. Upon termination, if Grantor and Husband, are then living, the trustee is directed to retain the trust property in a separate trust (the Family Trust) upon the following terms and conditions: During Husband’s lifetime, the trustees may distribute to Grantor’s issue as much of the trust property as trustees determine for any reason not prohibited by Trust. Any income not distributed within d days of the end of a calendar year are to be added to principal. Upon Husband’s death, the trustees are to distribute the trust property to any one or more persons or entities, excluding Husband’s creditors, his estate, or the creditors of his estate, in such amounts or proportions and upon such terms, conditions, or trusts as Husband appoints by will containing an express reference to this power of appointment. The trustees are to distribute any unappointed trust property to Grantor’s issue, per stripes.

Section 1.3 further provides that if Grantor is then living but Husband is then deceased, the trustee is directed to distribute the trust property to Grantor's issue, per stirpes. If Grantor is then deceased and if Husband survives Grantor (regardless of whether he is living when Trust terminates), the trustee is directed to distribute the trust property to Husband or his estate, as the case may be. If Grantor is then deceased and if Husband fails to survive Grantor, the trustee is directed to distribute the trust property to Grantor's issue, per stirpes.

Section 2.4 provides, in relevant part, that Grantor's primary purpose is to have the retained annuity interest meet the requirements of a qualified interest as defined in § 2702(b)(1) and § 25.2702-3 of the Gift Tax Regulations. The trustees are not to exercise any power, authority, or discretion if the effect of such exercise would be to defeat such purposes. In furtherance of such purpose, section 2.4A prohibits the trustees from making a distribution of trust property to anyone other than Grantor or her estate and section 2.4B prohibits commutation of the interest of Grantor or Grantor's estate in Trust.

Pursuant to Article II of Trust, the trustee has broad powers to invest, dispose of and otherwise deal with property in Trust, whether originally contributed to Trust or previously substituted into Trust by Grantor, without the approval or consent of any other person.

Section 4.4 provides, in relevant part, that Grantor may acquire any or all property constituting trust principal by substitution of other property of equivalent value to the property acquired, measured on the date of substitution. Grantor may exercise this power without the consent of trustees. The power to acquire trust property may be exercised only in a fiduciary capacity. Action in a fiduciary capacity means action that is undertaken in good faith and in the best interests of Trust and its beneficiaries and subject to fiduciary standards imposed under applicable state law. The trust further provides that property is of equivalent value if the fair market value, for federal gift tax purposes, of property removed from the trust equals the fair market value, for federal gift tax purposes, of property placed in the trust.

Grantor intends to fund Trust with shares of Company 1, shares of Company 2, and cash valued at approximately \$  . It is represented that Company 1 and Company 2 are publicly traded on Exchange. Grantor proposes to exercise her power of substitution from time to time by transferring into Trust additional shares of Company 1 in exchange for shares of Company 2 or additional shares of Company 2 in exchange for shares of Company 1 and/or cash equivalents or other publicly traded securities. In all cases, Grantor either will transfer to or receive from Trust cash or cash equivalents in an amount necessary such that the total value of the assets transferred into Trust equal the total value removed from Trust incident to the exercise of the power of substitution.

It is represented that the present value of the right to receive Trust corpus on the termination of the GRAT term, determined in accordance with § 7520, exceeds 10% of the initial fair market value of the property transferred to Trust. It is also represented that the administrative and miscellaneous provisions of Trust, including section 4.4, also apply to Family Trust.

You have requested the following rulings:

1. Neither the existence nor the exercise of the power of substitution disqualifies Grantor's retained interest as a qualified interest under § 2702(b)(1).
2. The gift tax value of the Company 1 shares and the Company 2 shares will be determined in accordance with § 25.2512-2(b)(1) by valuing each stock at the mean between its highest and lowest quoted selling price on Exchange on the date of substitution.
3. Grantor's exercise of the power of substitution will not constitute a gift to Trust for gift tax purposes if the value of assets transferred to Trust equals the total value of assets transferred from Trust.
4. Trust is a grantor trust in its entirety with respect to Grantor both during the GRAT term and after its expiration.
5. Neither Grantor nor Trust will recognize any income or loss by reason of the exercise of the power of substitution.

#### Ruling 1

Section 2702(a)(1) provides that solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of the transfer), the value of any interest in the trust retained by the transferor or any applicable family member, as defined in § 2701(e)(2), shall be determined as provided in § 2702(a)(2).

Section 2702(a)(2)(A) provides that the value of any retained interest which is not a qualified interest shall be treated as being zero.

Section 2702(b) defines a qualified interest as: (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually; (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually); and (3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2) above.

Section 25.2702-3(b) provides that an interest is a qualified annuity interest only if it meets the requirements of §§ 25.2702- 3(b) and (d). Section 25.2702-3(b)(1)(i) provides, generally, that a qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest.

In this case, under section 4.4 of Trust, Grantor has retained the power to acquire Trust property by substituting other property of equivalent value to the property acquired, measured at the time of substitution. Under the terms of Trust, Grantor's power to acquire Trust property under this section may only be exercised in a fiduciary capacity. Based on the facts presented and the representations made, we conclude that neither the existence nor the exercise of the power of substitution, as described above, disqualifies Grantor's retained interest under § 2702(b)(1).

### Ruling 2 and 3

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the tax imposed by § 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed to be a gift and is included in computing the amount of gifts made during the calendar year. However, under § 25.2512-8, a transaction which is bona fide, at arm's length, and free from any donative intent will be considered as made for an adequate and full consideration in money or money's worth.

Under § 25.2512-1, the value of property, for gift tax purposes, is the price at which such property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. Section 25.2512-2(b)(1) provides that, in general, if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond.

In this case, under the terms of Trust, Grantor may substitute property of equivalent value for Trust property. Grantor proposes to transfer additional shares of Company 1 for shares of Company 2 that Trust currently holds or additional shares of

Company 2 for shares of Company 1 that Trust currently holds. In addition, if necessary, Grantor will transfer to or withdraw from Trust cash or cash equivalents or other publicly traded securities in an amount necessary to make the total value of the assets transferred to Trust equal to the total value of the assets withdrawn from Trust as a result of the substitution. It is represented that the value of the Company 1 stock and the Company 2 stock subject to the proposed exchange will be determined in accordance with § 25.2512-2(b)(1) as of the date of the exchange. Based on the facts presented and the representations made, we conclude that the exercise by Grantor of the power of substitution will not constitute a gift to Trust for gift tax purposes if the total fair market value of assets transferred to Trust equals the total fair market value of assets transferred from Trust.

#### Rulings 4 and 5

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 672(e)(1)(A) provides, in general, that a grantor shall be treated as holding any power or interest held by any individual who was the spouse of the grantor at the time of the creation of such power or interest.

Section 673(a) provides, in general, that the grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

Section 674(a) provides, in general, that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Section 1.671-3(b)(3) of the Income Tax Regulations provides, in part, that a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under § 674 or § 676 as an owner because of a power over corpus which can affect income received such that he would be treated as an owner under § 673 if the power were a reversionary interest.

Rev. Rul. 85-13, 1985-1 C.B. 184, concludes that if a grantor is treated as the owner of a trust, the grantor is considered to be the owner of the trust assets for federal

income tax purposes. A grantor's receipt of the corpus of a trust in exchange for an unsecured promissory note was treated as an unsecured borrowing of the trust corpus which caused the grantor to be treated as the owner of the trust under § 675(3). The transfer of the trust assets in exchange for the note was not recognized as a sale for federal income tax purposes.

Assuming the present value of the interest, determined under § 7520, which will pass to the Family Trust if both Grantor and Husband survive the GRAT term is more than 5% of the total value of the property contributed to Trust, and based solely on the facts and representations submitted, we conclude that Trust and Family Trust will each be grantor trusts all of which is treated as owned by Grantor under §§ 671 and 674 during Grantor's life because of Husband's power as trustee of Family Trust to distribute income and principal among Grantor's issue. None of the exceptions to § 674(a) described in §§ 674(b), (c), or (d) are applicable. Grantor's exercise of the power to substitute Trust or Family Trust assets therefore will not result in the recognition of any gain or loss by Grantor, Trust, or Family Trust for federal income tax purposes.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

George L. Masnik  
Chief, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures

Copy for § 6110 purposes  
Copy of this letter